- Debt financing does not dilute the ownership or control of the existing shareholders.
- Debt financing has a tax benefit as interest payments are deductible from taxable income.
- Debt financing has a lower cost of capital than equity financing as debt holders have a lower risk than equity holders.

- Disadvantages of debt financing:
  - Debt financing increases the financial risk of the firm as it has to pay fixed interest and principal payments regardless of its profitability or cash flow situation.
  - Debt financing may impose restrictive covenants on the firm's operations and decisions, such as maintaining a certain debt-equity ratio or a minimum level of liquidity.
  - Debt financing may limit the firm's ability to raise additional funds in the future as it may affect its credit rating or debt capacity.
- Examples of situations where each type of financing is more appropriate:
  - Debt financing is more appropriate when the firm has stable and predictable cash flows, low existing debt levels, high tax rates, and low growth opportunities.
  - Equity financing is more appropriate when the firm has uncertain and volatile cash flows, high existing debt levels, low tax rates, and high growth opportunities.

Q3. What is the difference between operating leverage and financial leverage? How do they affect the risk and return of a firm? (10 marks)

A3. The difference between operating leverage and financial leverage is:

1. Financial management is the process of planning, organizing, directing, and controlling the financial activities of a firm. Its scope includes all aspects of a firm's financial management, such as capital budgeting, dividend policy, working capital management, and risk management.
2. The different types of financial decisions that firms make can be broadly classified into three categories:
    - Investment decisions: These decisions relate to the allocation of a firm's financial resources to different assets,

PAPER # 5

Section A (Short Answer Questions)
Answer all questions.

1. What is financial management? (2 marks)
2. State the primary objective of financial management. (2 marks)
3. What are the different types of financial decisions? (2 marks)
4. What is financial planning? (2 marks)
5. What is working capital? (2 marks)
6. What is the difference between equity and debt? (2 marks)
7. What is capital budgeting? (2 marks)
8. What is dividend policy? (2 marks)
9. What is risk management? (2 marks)
10. What is financial markets? (2 marks)

Answers:

1. Financial management is the process of planning, organizing, directing, and controlling financial resources in order to achieve the organization's objectives.
2. The primary objective of financial management is to maximize shareholder wealth.
3. The different types of financial decisions are:

    - Investment decisions
    - Financing decisions
    - Dividend decisions
4. Financial planning is the process of forecasting future financial needs and developing strategies to meet those needs.
5. Working capital is the difference between current assets and current liabilities.
6. Equity is the ownership interest in a company. Debt is the money that a company owes to creditors.
7. Capital budgeting is the process of evaluating long-term investment projects.
8. Dividend policy is the policy that a company follows when deciding how much of its profits to distribute to shareholders as dividends.
9. Risk management is the process of identifying, assessing, and managing risks.
10. Financial markets are places where financial assets, such as stocks, bonds, and currencies, are traded.

Section B (Long Answer Questions)
Answer any two questions.

11. Discuss the different factors that affect financial planning. (15 marks)
12. Explain the different methods of capital budgeting. (15 marks)
13. Discuss the different types of risks faced by businesses and how to manage them. (15 marks)

Answers:
11. Factors that affect financial planning:

- Internal factors: These are factors that are within the control of the business, such as the business's goals, strategies, and resources.
- External factors: These are factors that are outside the control of the business, such as the economic environment, government policies, and competitive landscape.

12. Methods of capital budgeting:

- Payback period: This method calculates the number of years it will take for the project to generate enough cash flow to cover its initial cost.